



Internal Revenue Service
Small Business and Self-Employed
Taxpayer Education and Communication



Tax Information for Small Business

Consider it Done



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Accounting Methods For Construction Contracts



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Accounting Method

A set of rules used to determine when and how income and expenses are reported.

	CASH METHOD	ACCRUAL METHOD
Income	Include all monies actually or constructively received	Include amounts when the product or service is provided
Expenses	Deduct when actually paid	Deduct when the expense is incurred



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Must Use Accrual Method

If incorporated or in a partnership with a C corporation and average annual gross receipts exceed \$5 million.

Personal Service corporations and farm businesses can use cash method.

Tax shelters never can use the cash method.
I.R.C. § 448.



Must Use Accrual Method

When the production, purchase, or sale of merchandise (materials) is deemed to be an income-producing factor (for example, when the cost of such exceeds a minimum percentage of the gross receipts), inventory accounting and the accrual method are required to properly reflect income, even if first requirement does not apply.



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Exceptions to Second Requirement for Use of Accrual Method

1. If accrual method is not required by statute, and taxpayer is not in a prohibited class, cash method is allowed when average annual gross receipts are less than \$10 million

Rev. Proc. 2002-28

2. If taxpayer is in a prohibited class, cash method is allowed if average annual gross receipts are less than \$1 million

Rev. Proc. 2001-10



Restricted Cash Method

If the cash method is allowed for taxpayers with significant inventories of merchandise or materials due to the Revenue Procedures, the cost of purchases cannot be deducted until the merchandise is sold (“consumed”) or paid for, whichever is later.



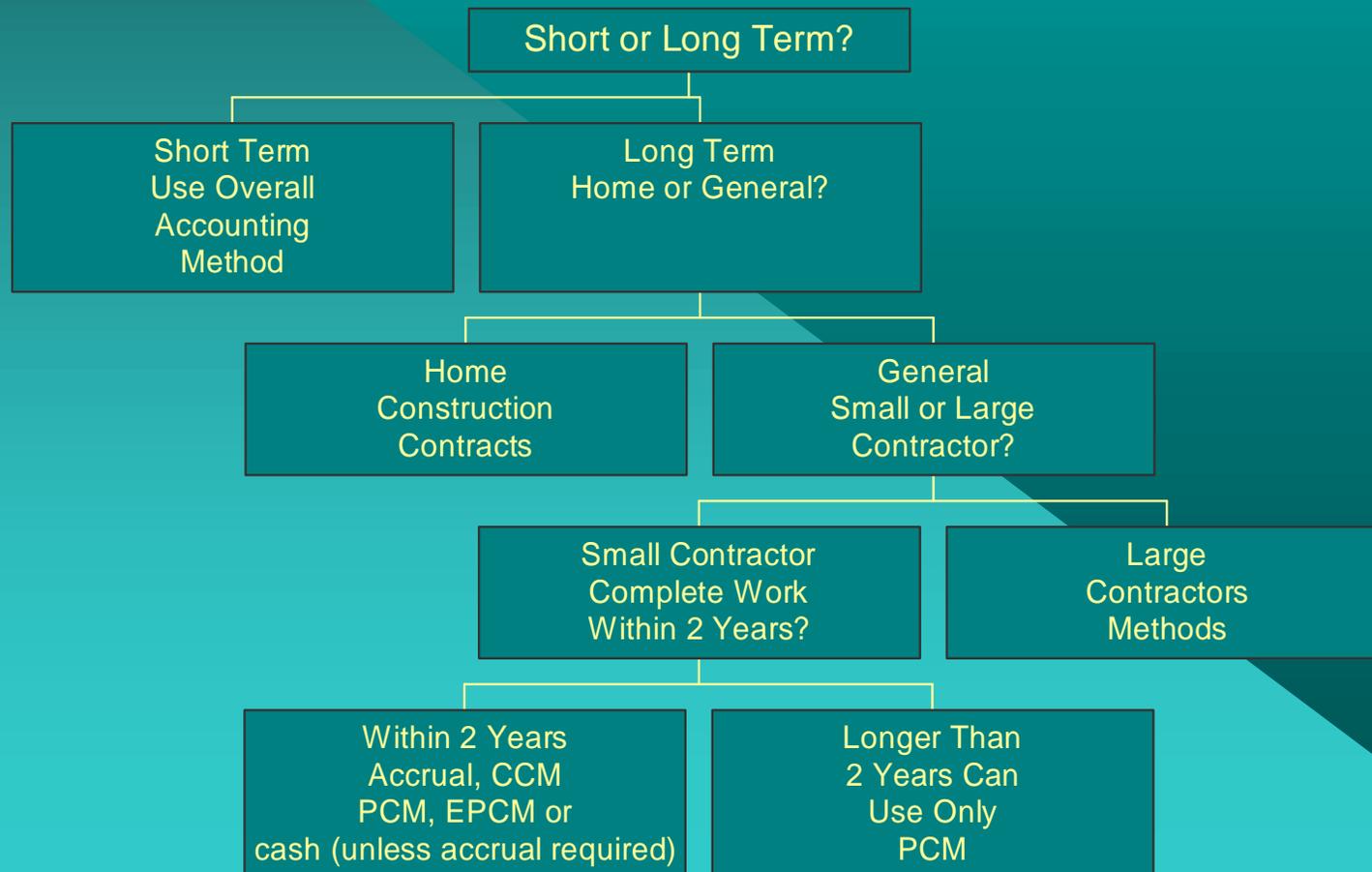
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Accrual Method

Construction contracts (I.R.C. Section 460)





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Short vs. Long-Term Construction Contracts

Short term contracts start and finish within the same tax year.

Can use cash (unless accrual method required) or accrual method.

Example:

If you have a contract that starts on 12/26 and ends on 1/23 of the next year, you have a long term contract.



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Homes vs. General Construction Contract

Home Construction

80% of total estimated contract costs are for construction, improvement, or rehabilitation of buildings that have four or fewer residential units.



General Construction Contracts

Large Contractor

Definition: Average gross receipts for the last 3 years was greater than \$10M.

Large Contractor must use Percentage of Completion

Method (PCM):

- Cost Comparison Method or
- Simplified Cost Comparison Method
(reduced cost allocation requirements)



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General Construction Contracts

Small Contractor

Definition: Average gross receipts for the last 3 years was \$10M or less.

The accounting method depends on whether construction will take more than 2 years.



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Small Contractor

Construction over 2 years duration

Use the percentage of completion method (PCM) for all construction over 2 years in duration.



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Small Contractor

Construction Duration 2 Years or Less

As a small contractor, you can use the

Cash (unless accrual method required)

Accrual

Percentage Completion Method (PCM)

Exempt-Contract PCM (EPCM)

Completed Contract Method (CCM)



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Exempt – Contract PCM

Any reasonable comparison of cost incurred to date with estimated total cost

Comparison of work to date with estimate of total work required



Cost Comparison Method

- ✓ Divide job costs incurred through end of year by estimated total job costs.
- ✓ Multiply this percentage by contract price to determine Cumulative Gross Receipts (CGR) through end of year.
- ✓ Subtract the CGR calculated through preceding year from CGR calculated through current year.
- ✓ Difference is Gross Receipts figure for current year.



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Example of PCM Cost Comparison Method Based on a Total Contract Price of \$1,000,000

	Year 1	Year 2	Year 3
Cumulative Costs	\$200,000	\$600,000	\$750,000
Estimated Total Costs	\$800,000	\$900,000	\$750,000
Completion Factor	25%	67%	100%
Cumulative Gross Receipts (CGR)	\$250,000	\$666,667	\$1,000,000
Prior Years CGR	-- 0 --	(\$250,000)	(\$666,667)
Current Year Gross Receipts	\$250,000	\$416,667	\$333,333



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Work Comparison Method

- ✓ This percentage of work completed must be certified by architect or engineer.
- ✓ Multiply this percentage by contract price for Cumulative Gross Receipts (CGR) through end of current year.
- ✓ CGR through current year less CGR through previous years produces Gross Receipts for current year.
- ✓ Divide work completed to date by estimated work needed to finish job.



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Completed Contract Method

Report all income from the contract and deduct all related job costs in the year the project is completed and accepted by the customer.



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Home Construction Contracts

Types of Home Construction	Small Contractors	Large Contractors
Spec Home	Spec Home Rules	Spec Home Rules
Custom Built Home	Accrual CCM or Cash* EPCM	Capitalization Rules of IRC Section 263A apply

* unless accrual required



Definitions

<p>Homes Built for Speculation (Spec Home Rules)</p>	<p>All direct and indirect costs are accumulated. Costs are part of the basis for the property and cannot be deducted until the home is sold.</p>
<p>Custom Built Home</p>	<p>Home built for a specific customer.</p>



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Type of Costs

- General and Administrative (G&A) Expenses
- Direct Job Costs
- Indirect Cost Allocation



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General and Administrative Expenses

General and administrative expenses are the indirect costs of operating a construction business that cannot be traced to a specific job.

General & administrative expenses are deducted when incurred or paid



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Direct Job Costs

Labor, materials, and subcontractor expenses can be traced directly to the construction project.



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Indirect Cost Allocation

Indirect job costs involve expenses that benefit more than one job and must be allocated among all the jobs that received the benefit.



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Thank You!